

Public Meeting

Dec. 20, 2006

R-05-7

Review of Implicit and Explicit
Subsidies

FCC 1st Report and Order
Universal Service Docket 96-45
May 8, 1997

Today, universal service is
achieved largely through
implicit subsidies. (para 10)

FCC 1st Report and Order
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When we refer to “implicit subsidies” in this discussion we generally mean that a single company is expected to obtain revenues from sources at levels above “cost” (i.e., above competitive price levels), and to price other services allegedly below cost.
(para 11, fn 15)

Types of Potential Implicit Subsidies Referenced by FCC

- Geographic Rate Averaging
 - Local rates within a study area
 - Long distance rates
- Access Charge Pooling
- Residential v Business Rates
- Recovering Loop costs through usage sensitive rates

Telecom Act: Section 254(e)

- Universal Service Support
 - Only ETCs shall be eligible to receive specific Federal universal service support
 - Such support shall be used only for the provision, maintenance, and upgrading of facilities and service for which the support was intended
 - Any such support should be **explicit** and sufficient to achieve the purposes of this section.

FCC 1st Report and Order
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States [] must [] be responsible for identifying intrastate implicit universal service support. We further believe that, as competition develops, the marketplace itself will identify intrastate implicit universal service support, and that states will be compelled by those marketplace forces to move that support to explicit, sustainable mechanisms... (para 14)

When must states eliminating Implicit Subsidies?

- The FCC left to the states to determine when implicit subsidies should be eliminated from intrastate rates:
 - “We find that the record does not support claims that, to comply with the court’s remand, we must require or induce all states to immediately remove implicit subsidies from intrastate rates through substantial increases in federal support..... Carriers arguing that immediate, nationwide rate rebalancing is urgently needed have not provided data to quantify the implicit support in intrastate rates. Moreover, they do not seem to consider the possibility that competition may drive costs down so that the total amount of support needed may decrease as competition increases.” Order on Remand, FCC-03-249, para 77
 - “[S]tates continue to be in the best position to determine when to eliminate implicit support in their rate designs and establish explicit, sustainable universal service mechanisms.” Id. Para 77
 - “We anticipate that the erosion of implicit support by competition will, in time, compel states to replace those implicit support mechanisms with explicit support mechanisms, which will be sustainable in a competitive marketplace.” Id., Para 78

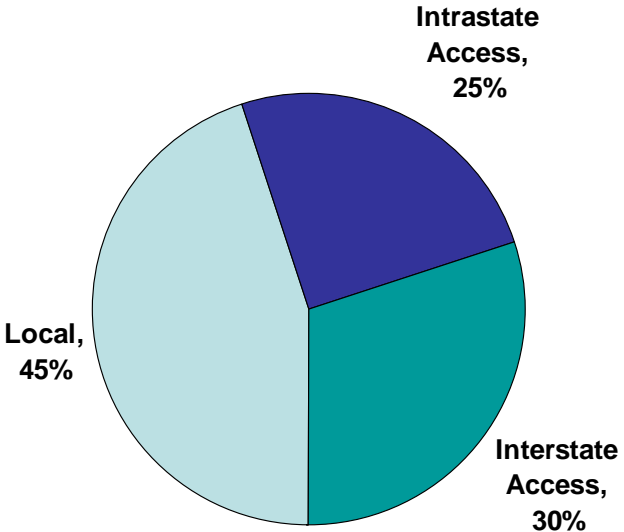
Must the Commission Remove Implicit Subsidies?

- The argument that including implicit subsidies in local rates contravenes the Act was rejected by the United States Court of Appeals, Tenth Circuit, in a recent case (2005) involving use of federal universal service funds:
 - “Qwest and SBC deduce a statutory mandate requiring state to transition from implicit to explicit support mechanisms. We reject this argument. In drafting the statute, Congress unambiguously imposed an explicit subsidy requirement on federal support mechanisms; no such requirement is expressly imposed on the states.” Qwest v. FCC
- The court also stated:
 - Nor did Congress expressly foreclose the possibility of the continued existence of state implicit support mechanisms that function effectively to preserve and advance universal service.

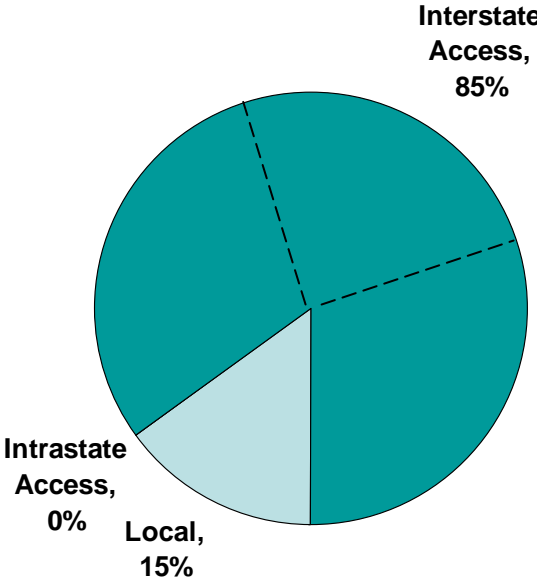
An Implicit to Explicit Subsidy: Switching Support

- Access charge ratemaking previously allowed certain small ILECs to weight switching costs up to 3 times their actual cost when computing access charges.
- This over-recovery of access charge costs permitted a corresponding reduction to local rates.
- After the Telecom Act, this implicit subsidy was converted to an explicit subsidy through the Universal Service Fund.
 - In Alaska: Intrastate DEM Weight Support
 - Interstate: Local Switching Support

Implicit Subsidy: Switching Costs

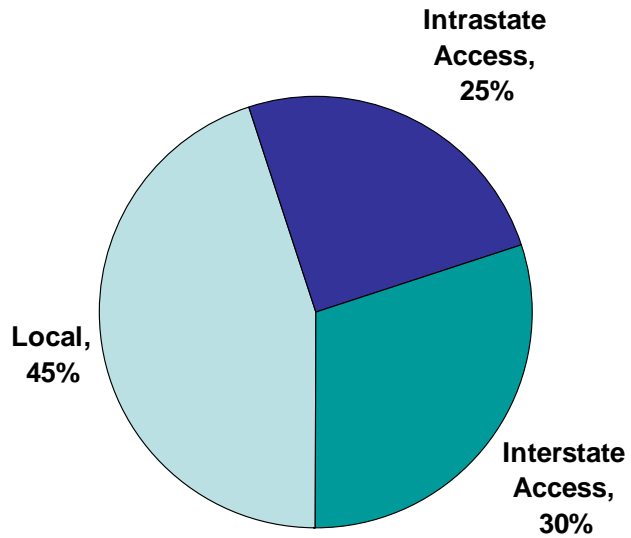


Allocation Based upon Usage

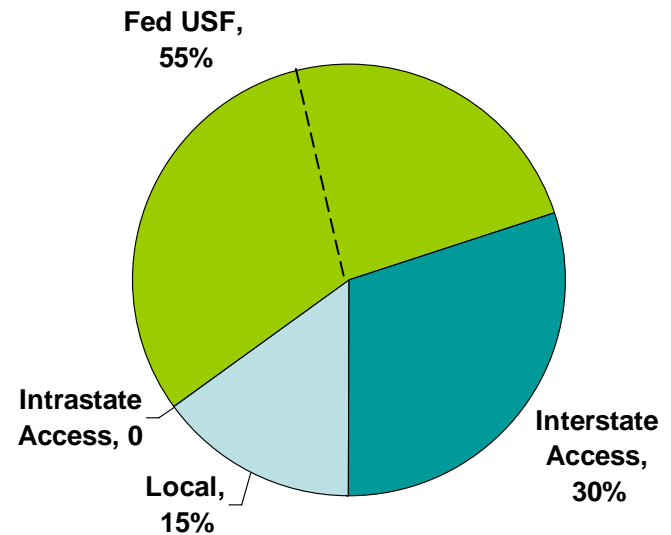


Weighted Allocation (with implicit subsidy)

Explicit Subsidy: Switching Costs

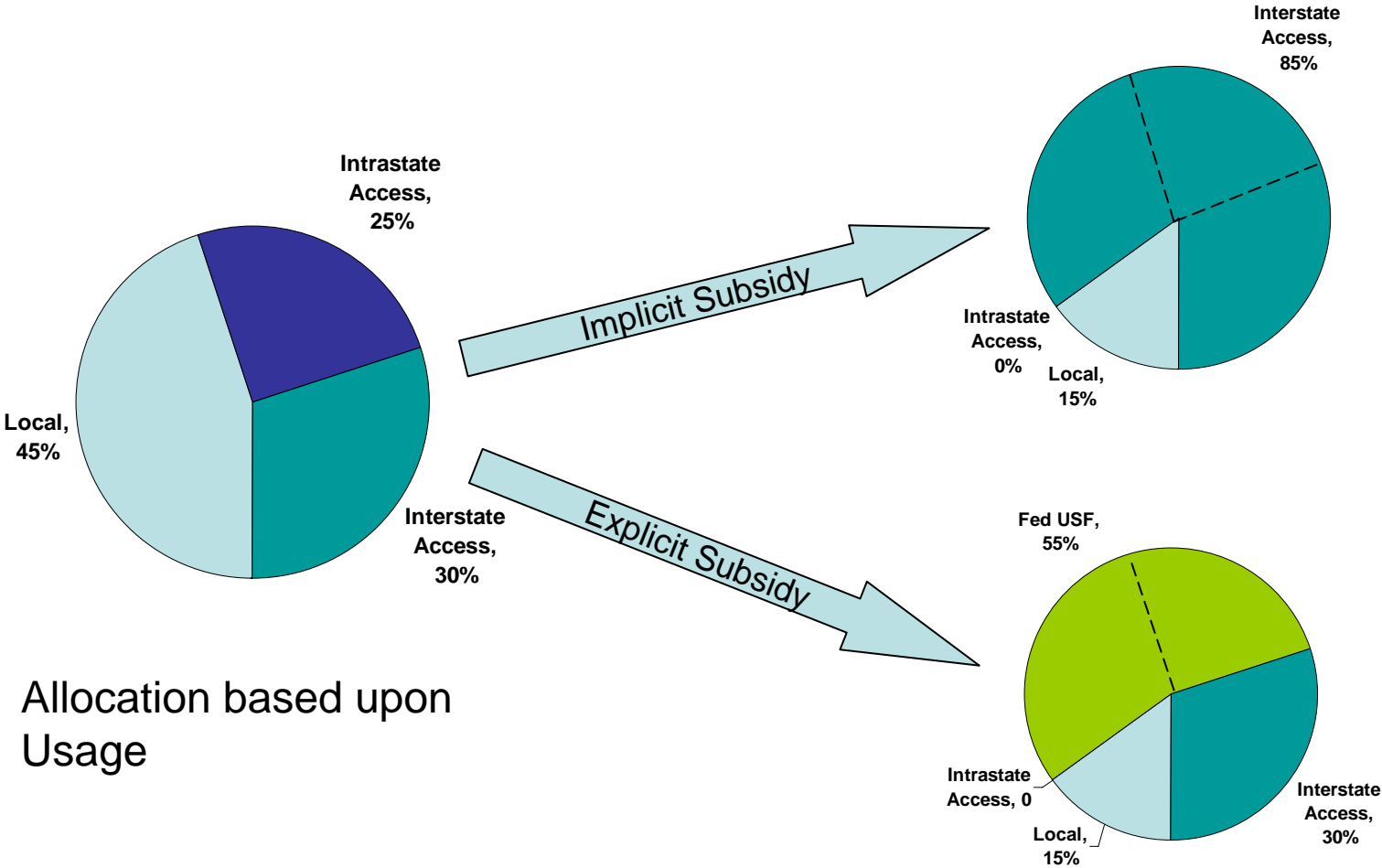


Allocation based upon Usage



Weighted Allocation (with Explicit USF Support)

Switching Costs: Implicit v Explicit Subsidy



Rate Averaging and Subsidy

How do you determine whether an averaged rate involves a subsidy?

- One standard used by this Commission in the past: If rates exceed marginal cost there is no subsidy.
- However, the Telecom Act requires a different standard for allocating the costs of universal services.

Section 254(k): Subsidy of Competitive Services Prohibited

- A telecommunications carrier may not use services that are not competitive to subsidize services that are subject to competition.
- States shall insure that universal service services bear no more than a reasonable share of the joint and common costs of facilities used to provide those services.